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REMARKS

Recent IMF reports corroborate the study on direct intervention that I cited in the attached memo. (Figures on direct intervention are available through 1981).

State Dept. review completed

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DEPARTMENT OF STATE
THE DIRECTOR OF INTELLIGENCE AND RESEARCH
WASHINGTON

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MEMORANDUM

January 7, 1982

TO: EB - Mr. Richard McCormack

FROM: INR/OD - Hugh Montgomery

SUBJECT: The Degree to Which the Japanese Manage the Exchange Rate of the Yen

Our review of Japanese actions with respect to exchange rate management tends to support Mr. Tresize's observation that the Japanese have abandoned the practice of active interventions. INR and CIA have not done any in-depth study of the issue in the last three to four years because exchange rate intervention has receded as a major trade policy problem. There have, however, been simulations of trade results based on different values of the yen. Our review relies heavily on studies made by respected economists outside of the US government and by the IMF.

The Japanese have recognized that their ability to influence the value of the yen is limited--a fact demonstrated convincingly by events in 1978 (when the yen soared from 240 to 175) and then 1979-80 (when it plummeted below 260). Japanese monetary officials have apparently realized that the different international economic environment of the 1980s--slower growth, higher inflation, and an uncertain oil price and supply situation--will require a considerably different approach to currency management than that which prevailed in the postwar decades.

Moreover, the Japanese have learned to live with a stronger yen. For Japan, the yen's steep appreciation over the past decade had an important beneficial spillover effect. It lowered the real cost of oil imports obtained through dollar transactions, and the lower energy import bill, in turn, served to hold down inflation rates and maintain export competitiveness.

Critics frequently point to the fact that every large fluctuation in the yen has triggered a major reversal in official policy toward capital inflow and outflow. While this tendency has certainly been a salient feature of Japanese policy, a more relevant fact is that in recent years, several major liberalizations in the country's foreign exchange laws have reversed a series of major restrictions in effect since the end of the Second World War. Legislation eliminating remaining restrictions on foreign exchange transactions, except in times of emergency, was implemented

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in late 1980. The modifications indicate a change in official attitude toward external capital transactions from "restricted in principle and free on approval" to "free in principle and restricted only in special cases" with special cases taken to mean events such as a major deterioration in the balance of payments or chaos in the foreign exchange markets.

EVOLVING EXCHANGE RATE POLICY: 1973-1980

Attempts to counter yen appreciation following the suspension of dollar-gold convertibility in 1971 taught Japanese authorities that the inflationary consequences of massive exchange-rate intervention could take a severe toll and lead to even more drastic deterioration in the balance of payments. In the 1973 economic white paper, the Japanese government recognized the contribution that a more flexible exchange rate can make in achieving economic goals--a reversal of the previously-held position that a rigid exchange rate was a matter of dogma and a moral imperative. Beginning in 1974, Japan's exchange rate policy underwent further modifications, as the government began to accept less responsibility for setting spot rates and began to let the market fluctuate more from day to day, within the limits set by existing exchange controls.

Direct Intervention

An IMF study of Japanese exchange rate policy from March 1973-October 1976 presented evidence refuting the view that intervention in the foreign exchange market had been aimed at establishing a target level for the yen. Rather, Japanese intervention behavior had sought to moderate movements in the yen/dollar exchange rate in <u>either</u> direction by providing sustained support to either the dollar or the yen.

In each case, the intervention lasted for periods exceeding two months and up to 8 months (as in 1976). Over this period, each 1 percent monthly movement in the exchange rate was generally accompanied by a net intervention of about $240 million. During this period of intervention, the IMF concluded that changes in domestic/foreign interest rate differentials and anticipated changes in the current balance of payments were still the significant factors in determining exchange rate movements.

Indirect Intervention

An IMF study of the Japanese experience from 1978-80 illustrated the influence on exchange rates of capital controls--a device which played an increasingly more important role than direct intervention in the late 1970s. Measures to influence capital flows were introduced to narrow the amplitude of exchange rate fluctuations. For example, in early 1978, when appreciation

of the yen was widely expected, capital controls were introduced to reduce net inflows; in 1979 and 1980, when the government thought that the yen had weakened too rapidly, measures aimed at inducing net inflows were introduced. These policy changes are frequently credited with having had an important impact on the exchange rate, and the efficiency of the foreign exchange market.

The study showed that the distortions in the foreign exchange market created by Japanese capital controls were declining except for a period in the first quarter of 1980, when a package of yen defense measures was introduced. The increase in distortions during that period reflected moral suasion exercised by authorities to encourage Japanese corporations to bring in more funds from abroad to halt a too-rapid decline of the yen. The increasing liberalization of Japanese foreign exchange laws had led to a foreign exchange market in Tokyo that, according to the IMF study, appeared at the end of 1980 to be as free from distortions as the London market.

THE 1981 EXCHANGE RATE DILEMMA

The yen strengthened to 200 against the dollar at the end of 1980 and it seemed likely that the trend would continue. Japan was moving into a current account surplus after 2 years in the red (the 1980 current account deficit was $10.8 billion). But instead of continuing to appreciate, the yen weakened and fell to 245 to the dollar.

The weakening of the yen came soon after the dramatic increase in US interest rates at the end of 1980 and during the first half of 1981--the main cause of the dollar's renewed strength. The long-term capital movement out of the yen amounted to a massive $5.7 billion in the second quarter of 1981, swamping the current account surplus of $1.5 billion over the same period.

Japanese plans for 1981 had called for economic growth to be led more by an expanding domestic economic sector than by exports. The Japanese official discount rate was trimmed to 6.25% from 7.25% on March 17, 1981--the third time in 9 months. But, because of high US interest rates, Japan, like the West European countries, had to postpone plans for further cuts in interest rates meant to stimulate domestic economic expansion.

The combination of a lagging domestic economy--and thus reduced import demand--and a cheaper yen--resulted in a current account surplus of about $6 billion for 1981, much larger than earlier projections of a balance, or a slight surplus in the current account. The increasing current account surplus played an important role in the rally of the yen to a November 30 peak of 214.50 to the dollar, although market forces ("discounting") caused a slide toward 220 yen to the dollar by the first week of December.

With the more recent cuts in US interest rates, the Bank of Japan was able to cut its official discount rate on December 10, 1981 from 6.25 percent to 5.5 percent, without lowering the yen value. Japanese bankers and analysts believe it will take time for this interest rate reduction to affect economic activities, including imports.

There are several issues that may be worthwhile examining later--the problems of US banks operating within the Japanese financial system, the prospects for and implications of internationalization of the yen, and the role of services in the overall US-Japanese trade picture. INR is undertaking studies of the trends in Japanese overseas investments and the changes in Japan's financial system, planned for completion by March, which may be of interest to you.

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